*United States Court of Appeals*

*for the Second Circuit*

# APPELLEE'S BRIEF

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74-1406

No. 74-1406

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

NATHAN CUMMINGS AND JOANNE T. CUMMINGS,

Appellees

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant

ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

# BRIEF FOR THE APPELLEES

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## NATURE OF THE ISSUES

The government has incorrectly stated that the issue in this case is whether a payment made under §16(b) of the Securities Exchange Act of 1934 must be treated as a long-term capital loss since the payment is effectively an adjustment with respect to an earlier sale of stock

which had been taxed at favorable long-term capital gains rate. (Govt. brief, p. 1)

The issues are these:

1. Whether the payment was made for valid business purposes - to protect a taxpayer's business reputation and to fulfill his fiduciary duties as a director by avoiding a delay in the issuance of a proxy statement, after a potential §16(b) problem had arisen but before any corporate demand for payment or any opportunity to secure legal advice on the matter. The Tax Court held that the payment was motivated by business purposes, and the government does not seriously press the issue here.

2. Whether this Court should undertake to decide the issue of taxpayer's §16(b) liability in spite of the facts that (i) no such determination has ever been made in this case, (ii) the issue cannot be decided on the basis of the present record,

and (iii) the tax characterization of the payment should not be decided by reference to what taxpayer's §16(b) liability might have been in the abstract.

3. Whether - if this Court elects to decide the §16(b) liability issue - taxpayer actually violated §16(b) and had no possible defenses.

4. Whether - and only if this Court decides the preceding two issues adversely to taxpayer - deductibility must be denied on §16(b) policy grounds.

5. Whether the Arrowsmith doctrine or the tax benefit doctrine mandates capitalization of the payment, irrespective of taxpayer's business purposes.

## STATEMENT OF FACTS

Although the facts are undisputed, the government's statement of the case is unsatisfactory in its presentation of the circumstances surrounding the payment at issue.

On January 16, 1962, the Division of Corporation Finance of the Securities and Exchange Commission (SEC) wrote a letter to the secretary of Metro-Goldwyn-Mayer, Inc., giving its comments on the preliminary proxy solicitation material which MGM had prepared for its annual stockholders meeting to be held on February 23, 1962. (R. 10, 77-78) The letter noted that Nathan Cummings - an MGM director and the taxpayer in this case - had purchased 3,000 shares of MGM stock during September and October of 1961, after having sold a like number within the previous six months, and added:

> "If he has realized any material profits from these transactions which under Section 16(b) of the Securities Exchange Act of 1934 inure to and are recoverable by the issuer, the pertinent facts with respect to these transactions should be disclosed in the proxy statement pursuant to Item 7e." (R. 10, 78)

Upon receipt of the SEC letter, the secretary of MGM immediately informed Mr. Cummings of its contents. (R. 78) Mr. Cummings believed that if any §16(b) violation had occurred, it had been solely the result of inadvertence. (R. 78-79) However, so as not to delay the issuance of MGM's proxy statement and so as to avoid the impact which disclosure of his <u>potential</u> §16(b) liability might have on his business reputation, Mr. Cummings immediately decided to pay MGM $53,870.81. (R. 45-46, 79, 97-98) This decision was made by Mr. Cummings without legal advice, and without any recognition by Mr. Cummings that he had a legal duty to make the payment. (R. 98)

As a result of Mr. Cummings' payment, which was made the day after MGM received the SEC letter (R 11), MGM was able to print its proxy statement without any reference to the problem raised in the SEC letter. (R. 12-17, 79)

On February 1, 1962, Mr. Cummings received from his personal financial assistant a memorandum calling

his attention to a situation in which a corporation had not required an insider to make payment of a §16(b) profit to the corporation because the violation was inadvertent. (R. 18-22) The memorandum concluded:

> "Basically, it seems the purpose of reporting sales and profits is to prevent insiders from making profit on so called insiders knowledge. Quite obviously this was not what occurred here and equally as obvious is the fact that the shares were purchased through 'inadvertence'.
>
> Under the circumstances, I firmly feel that Metro-Goldwyn-Mayer should return the $53,870.81 to you and refuse to make claim on you for it." (R. 18-19)

On the basis of this memorandum, Mr. Cummings wrote to the secretary of MGM on February 6, 1962 to request a refund of the payment which he had made. (R. 23, 79) On February 9, 1962, Mr. Cummings was informed by MGM that the matter had been referred to independent counsel for its opinion. (R. 24, 79)

On February 20, 1962, the law firm to whom the matter had been referred recommended that MGM not

refund the payment to Mr. Cummings. In their opinion letter, counsel stated that "it has been held in the one case on the point that the determination of whether or not a company should make a claim under Section 16(b) against an officer or director is a matter left to the discretion of the directors." (R. 28) However, the letter concluded that there was no authority for refunding a payment once it had already been voluntarily paid to the company. (R. 28) In view of counsel's advice, no refund was ever made to Mr. Cummings. (R. 79)

The payment was deducted by Mr. Cummings on his 1962 tax return as an ordinary loss, and the Commissioner determined that the payment was a long-term capital loss. (R. 80)

On April 23, 1973, the Tax Court held that the payment was properly characterized by Mr. Cummings as an ordinary and necessary business expense. (R. 74-85) In reaching this decision, the Tax Court found that Mr. Cummings' payment was motivated by valid business purposes:

"Furthermore, we find that the payment was made to protect the business reputation of the petitioner and to avoid delay in the issuance of the MGM proxy statement. The respondent suggests that the petitioner made the payment merely because he was required to do so as a matter of law and contends that the disclosure of an apparently innocent violation of Section 16(b) would not have blemished the petitioner's business reputation. Yet, the petitioner could not control the reporting of the circumstances to the business community; and it was not unreasonable for the petitioner to believe that his business reputation, which he considered to be his most important asset, might be damaged by incomplete reporting, by people not completely understanding the circumstances, or by mere association with an alleged securities violation. In addition, the timing of the events supports the petitioner's statement as to his reasons. Immediately after learning about the problem, he agreed to make the payment to MGM, and clearly there was insufficient time for him to have secured considered legal advice as to his liability to MGM. If he had made the payment because of a belief that he was required to do so, he surely would have sought such legal advice, and more time would have been required to secure such advice and to make a decision based upon it." (R. 84-85)

The Tax Court also held, consistent with its earlier decisions in the Anderson and Mitchell cases,

that the Arrowsmith doctrine did not require capitalization of Mr. Cummings' payment because the payment was not directly and integrally related to the earlier sales transaction. (R. 82-83)

Subsequent to the Tax Court's decision, the Seventh Circuit Court of Appeals reversed the Tax Court in Anderson v. Comm'r, 480 F. 2d 1304 (7th Cir. 1973).

On July 5, 1973, the government moved for a reconsideration and revision of the Tax Court's opinion, on the theory that the Seventh Circuit's discussion of the Arrowsmith doctrine warranted reconsideration of that issue by the Tax Court. In moving for reconsideration, the government expressly stated that it was abandoning its argument that Mr. Cummings' payment was not motivated by valid business purposes:

> "The respondent does not now argue that Code §162(a) is not applicable in the instant case, but only that the Arrowsmith v. Commissioner, supra rule is controlling and that the result dictated by Code §162(a) cannot be given effect." (R. 89)

In view of the fact that the government's time for appeal had nearly expired, Judge Simpson vacated the Tax Court's decision on July 9, 1973 and granted the government's motion for reconsideration. (R. 92)

On October 2, 1973, the Tax Court reaffirmed its April 23, 1973 opinion, and again held that Mr. Cummings' payment was deductible under the particular circumstances of the case. (R. 93-100) In its reaffirming opinion, the Tax Court carefully considered the Seventh Circuit's Anderson decision, and concluded on several grounds that the decision should not be followed in this case. First, the Tax Court noted that the Seventh Circuit appeared to have assumed in Anderson that there was a violation of §16(b) and that the payment was made in satisfaction of a liability resulting from such violation. But the Tax Court noted that:

> "However, in Anderson, and also in the case before us today, there has been no determination that the taxpayer violated section 16(b) or that he was liable under that section to

> make any payment. As we pointed out before, Mr. Cummings made the payment promptly after learning of the position taken by the Securities Exchange Commission (SEC); he acted without legal advice; and these circumstances indicate clearly that the payment was not made because of a recognition of a legal duty to do so. On the contrary, it is clear that the payment was made for business reasons and for reasons growing out of his responsibility as a director of MGM." (R. 97-98)

Second, the Tax Court concluded that the Seventh Circuit had misapplied the Tank Truck Rentals doctrine (356 U.S. 30 (1958)) in holding that deductibility of the payment in Anderson would severely frustrate the purpose of §16(b). Since there was no §16(b) violation in Mr. Cummings' case, the Tax Court noted that a Tank Truck Rentals approach did not make sense. (R. 98-99)

Finally, the Tax Court determined that there was no integral relationship between Mr. Cummings' payment and his 1961 stock sale that would render the Arrowsmith doctrine applicable:

> "Had Mr. Cummings made the payment to MGM in the same year as the sale and purchase, there would have been no reason to require that the payment be offset against the gain realized on the sale. When he sold his MGM stock, he sold a capital asset and realized a capital gain. The subsequent purchase of other MGM stock for a lower price does not, as a matter of tax law, provide a basis for reducing or offsetting the capital gain already realized." (R. 97)

On December 28, 1973, the government filed a notice of appeal to this Court, where proper venue lies, since taxpayers' residence was in New York City at the time that their petition in the Tax Court was filed. (R. 105)

## SUMMARY OF ARGUMENT

The factual context of Mr. Cummings' payment to MGM is the key to this case. It was not a §16(b) payment, either in Mr. Cummings' view or in the opinion of the Tax Court. The payment was instead made to protect Mr. Cummings' business reputation and to avoid delay in the issuance of the MGM proxy statement. The SEC never stated that Mr. Cummings had violated §16(b). MGM never demanded that Mr. Cummings disgorge a §16(b) profit. Mr. Cummings consulted no attorney as to whether or not he had violated §16(b), or whether he might have any defenses, before making the payment. And no determination was ever made as to whether or not Mr. Cummings' 1961 MGM stock transactions in fact violated §16(b).

Under these circumstances, it makes no sense to invoke the legislative purpose of §16(b) to deny deductibility of Mr. Cummings' payment.

This Court cannot simply assume that Mr. Cummings was in violation of §16(b), and should not

undertake to make such a determination. Moreover, even if a §16(b) violation had occurred, there is no support either in the tax law or in the legislative purpose of §16(b) for exacting an additional penalty from Mr. Cummings on the supposition that Congress intended to deny deductibility of §16(b) payments regardless of taxpayers' motives or business purpose.

Capitalization of Mr. Cummings' payment is not mandated by the doctrine of Arrowsmith v. Comm'r., 344 U.S. 6 (1952). Under Arrowsmith, capitalization of an item is proper when it is so directly and integrally related to a prior capital transaction that the two transactions are in reality a unified whole.

Even an admitted §16(b) payment does not have such an integral tax relationship to the stock transactions which give rise to §16(b) liability. While it is true that but for the stock transactions, the violation would not have occurred, this fact alone does not establish the qualitative nature of the capital relationship required by Arrowsmith. When a sale of stock is followed

by a purchase within six months, the two transactions may be matched for §16(b) purposes. And yet, the resulting insider's profit bears no relationship to the income tax consequences of the stock sale; that sale might have resulted in a huge loss. Nor does the insider's profit have any relationship to the income tax consequences of the subsequent stock purchase, since that event can produce no tax result until the stock is sold. In fact, the insider's "profit" is an artificial creation for SEC purposes, as the Tax Court correctly stated in its Mitchell decision. (52 T.C. 170, 174-75 (1969)).

The Sixth Circuit's Mitchell opinion focused solely on the "but for" relationship, and hence missed the point. (428 F. 2d 259 (1970)) The Seventh Circuit's Anderson opinion forced the issue by declaring that the insider's profit can be styled an adjustment on the sale price, and then decided the case by reference to its view of the legislative purpose of §16(b). (480 F. 2d 1304 (1973)).

This case should not present the conceptual difficulties encountered by the Sixth and Seventh Circuits. It cannot even be argued that Mr. Cummings' payment was an adjustment on the sale price of his 1961 MGM stock transaction without first establishing that the payment was in satisfaction of a §16(b) liability. But on the undisputed facts, the payment was not made for the purpose of satisfying a §16(b) liability, and this Court should not decide whether Mr. Cummings might have been liable in the abstract. Such an approach is unnecessary if Arrowsmith and the nature of a §16(b) payment are properly understood.

The government's tax benefit arguments also suffer from this conceptual problem. Mr. Cummings was not giving back money previously taxed at preferential rates, since his payment had no tax relationship to his capital gain on the 1961 MGM stock sale. This is true irrespective of whether or not the payment can be styled a §16(b) payment, but here again, the undisputed facts make the lack of any connection irrefutable.

## ARGUMENT

### I

### MR. CUMMINGS' PAYMENT WAS MOTIVATED BY BUSINESS PURPOSES

In the proceedings below, the government conceded that Mr. Cummings' activities as an MGM director constituted a trade or business (R. 83). The Tax Court directly held that Mr. Cummings' payment was motivated by business purposes, and not by any reference to potential §16(b) liability:

> "Furthermore, we find that the payment was made to protect the business reputation of the petitioner and to avoid delay in the issuance of the MGM proxy statement.
>
> * * *
>
> In addition, the timing of the events supports the petitioner's statement as to his reasons. Immediately after learning about the problem, he agreed to make the payment to MGM, and clearly there was insufficient time for him to have secured considered legal advice as to his liability to MGM. If he had made the payment because of a belief that he was required to do so, he surely would have sought such legal advice,

> and more time would have been required to secure such advice and to make a decision based upon it. (R. 84-85)

The government now attempts - albeit halfheartedly - to dispute these findings of the Tax Court on the premise that Mr. Cummings was clearly in violation of §16(b) at the time he made the payment. (Govt. brief, p. 12)

Even if Mr. Cummings was in violation of §16(b) - a matter which to this day has not been determined - his subjective motivation in making the payment turns on what he perceived the problem to be, not what might have been true in the abstract. The facts as found by the Tax Court are undisputed that at the time Mr. Cummings made the payment, he did not believe that a §16(b) violation had occurred, and did not make the payment in the belief that he was in violation of §16(b). (R. 78-79; 84-85). Rather he was motivated by concern that inaction on his part might delay issuance of the MGM proxy statement, and that public disclosure of the problem might injure his business reputation, which he considered to be his most important asset. (R. 84)

The government cites no evidence indicating that these findings are erroneous. In fact, the government has no business raising this question at all, since it conceded the issue in its motion for reconsideration of the Tax Court's first decision:

> "The respondent does not now argue that Code §162(a) is not applicable in the instant case, but only that the Arrowsmith v. Commission, supra rule is controlling and that the result dictated by Code §162(a) cannot be given effect." (R. 89)

## II

## A VIOLATION BY MR. CUMMINGS OF §16(b) CANNOT BE ASSUMED AND SHOULD NOT BE DETERMINED

The government argues that Mr. Cummings' business reasons for making the payment are irrelevant, because the payment was in fact triggered by Mr. Cummings' violation of §16(b):

> "The liability for this payment arose solely because he engaged in short-swing transactions proscribed by Section 16(b). While business and personal reasons may have led taxpayer to pay this liability promptly, rather than to defer payment and litigate, it cannot transform the nature of this liability. (Govt. brief, p. 19)

Building on this assumed violation of §16(b) by Mr. Cummings, the government argues that the purpose of §16(b) would be frustrated by allowing deductibility of the payment, and that the Arrowsmith doctrine mandates capitalization because the payment was an adjustment to the sales price of Mr. Cummings' April 1961 MGM stock transaction.

But the basic premise of the government's theories - that there was a §16(b) violation - cannot simply be assumed. And, if the basic premise is not established, the government's arguments must fail.

Before even considering the government's contentions, therefore, this Court must first rule that, as a matter of law, Mr. Cummings' 1961 MGM stock transactions were in violation of §16(b) since this issue has never been determined.

The government suggests that this matter is simple to decide. (Govt. brief, pp. 11-12) But, even if this Court did determine that the elements of a §16(b) violation were present, it would then be forced to speculate as to whether Mr. Cummings had any defenses, or whether the payment would in fact have been demanded and subsequently exacted from Mr. Cummings by MGM. This question cannot lightly be brushed aside. Contrary to the government's statement that the record contains no reference to any defense, at least two potential defenses might have been raised by Mr. Cummings, both of which

have some support in the record.

1. Corporate discretion.

When Mr. Cummings requested a refund of his payment from MGM, based upon the concept that other corporations had refused to demand §16(b) payments from insiders who had inadvertently violated the statute (R. 18-23), the matter was referred by MGM to independent counsel for advice.

The opinion letter which MGM received (R. 26-28) confirmed that - had Mr. Cummings not made the payment - MGM's board of directors had the discretion to determine whether or not a demand should be made upon Mr. Cummings for the payment. (R. 28) But the letter advised that there was no legal basis for refunding the payment once it had been made voluntarily.

2. The lack of opportunity for speculative abuse.

At trial, Mr. Cummings testified that he was not even aware of the MGM stock transactions that gave rise to the §16(b) problem. (R. 46) At that time Mr. Cummings had a personal financial assistant who took care of these matters. (R. 45)

If in fact Mr. Cummings' stock transactions were not his decision, but that of his financial assistant, it could be argued that the opportunity for speculative abuse was absent, and therefore, §16(b) should not be applied.

The Supreme Court has held that the lack of opportunity for speculative abuse is an important factor to consider in determining whether borderline transactions are within the reach of §16(b). Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 93 S.Ct. 1736, 1744-45 (1973).

An exceptionally well-reasoned Note on the

Kern County case in the Michigan Law Review (72 Mich. L. Rev. 592, 624-25 (Jan. 1974)) concludes that, given the underlying purposes of §16(b), the lack of opportunity for speculative abuse test should apply with equal force to all §16(b) situations whether or not borderline in nature:

> "Although the statutory language is broad enough to reach all situations where abuse is possible, there is no reason to extend it to cover any situation - whether or not it involves an 'unorthodox' transaction - where abuse is impossible: 'Congress adopted the sweeping, arbitrary regulatory mechanism embodied in Section 16(b) in order to insure that even the possibility of insider abuse was deterred, but it would seem to follow that in order to avoid 'purposeless harshness' a court should first inquire whether a given transaction could possibly tend to accomplish the practices Section 16(b) was designed to prevent'. [citing Blau v. Lamb, 363 F. 2d 507, 519 (2d Cir. 1966), cert. denied, 385 U.S. 1002 (1967)]."

The author of the Note suggests that the "possibility of abuse" test should be determined by reference, first, to the foreseeability of the price change that led to defendant's profits at the time of his initial transaction, and second, to the question of whether the

public at large had access to the information upon which the defendant based his transaction decisions. (72 Mich. L. Rev. at 608-13)

In Mr. Cummings' case, the record does not indicate whether the price change in MGM's stock was foreseeable at the time of his initial transaction, but had Mr. Cummings resisted a hypothetical demand for payment from MGM, he would at least have had the opportunity to develop these facts. Second, while such evidence as is in the record suggests that - even if Mr. Cummings had access to inside information - his knowledge was isolated from the stock transaction decision, it would also have been possible to develop facts concerning the precise extent of Mr. Cummings' knowledge compared to information generally available to the public at the time of the MGM stock transactions, if Mr. Cummings had not made the payment.

The point of this discussion is not that Mr. Cummings would ultimately have been successful in avoiding §16(b) liability; it is that Mr. Cummings' liability was

by no means as inevitable when the payment was made as the government contends.

To require that Mr. Cummings now prove his innocence of §16(b) liability in order to establish deductibility of a payment admittedly made for business purposes is a total distortion of §162(a) of the Internal Revenue Code, and a reversal of the burden of proof in a §16(b) case. If this Court undertakes to determine the issue on the basis of the record in this case, it will in effect have deprived Mr. Cummings of the opportunity to defend himself, since the same business purposes that motivated his payment also mooted exploration of possible factual bases for defending a potential claim.

As the Tax Court opinion indicated, the Seventh Circuit in Anderson v. Comm'r, 480 F. 2d. 1304, 1308 (7th Cir. 1973) did assume that taxpayer in that case had violated §16(b), in spite of the fact that there had been no prior adjudication of any §16(b) liability. Without conceding the validity of the Seventh Circuit's

approach, it should be noted that in Anderson, unlike this case, there had been a formal demand on taxpayer by the corporation based upon the opinion of its legal department that taxpayer had violated §16(b) and that the corporation was entitled to the §16(b) profit realized by taxpayer. (480 F. 2d at 1305) Unlike this case, the taxpayer in Anderson took the opportunity to refer the matter to his attorneys, who were apparently unable to suggest any possible defense. (56 T.C. 1370, at 1372)

The difficult question, left unanswered by the Seventh Circuit's Anderson decision and by the government's approach in this case, is how far a court should go in deciding whether a §16(b) violation in fact occurred when no such determination was ever made. Is a court to make such a decision however complicated and uncertain is the §16(b) question? If the government's approach is to be applied only in cases of "clear" §16(b) liability, it becomes difficult to justify the distinction between clear and unclear liability cases in terms of the

government's profit-squeezing interpretation of §16(b). If the government is correct that §16(b) was designed to eliminate any possible §16(b) profit by denying income tax deductibility to any payment involving a potential §16(b) problem, surely any case in which an actual but undetermined violation occurred - no matter how complex - must fall within the scope of this legislature purpose.

This conceptual difficulty cannot be resolved by resorting to the argument that this case presents no such problems. In the first place, the §16(b) liability issue is not as clear as the government has made it seem. Second, and more fundamental, is the problem that deciding the ultimate liability issue is a totally unworkable, and probably unconstitutional means of implementing the legislative policy of §16(b) in the very context in which the policy has the least appeal: an admittedly inadvertent pattern of trading, coupled with a payment made for valid business purposes absent any recognition or indication of legal duty.

In summary, this Court cannot simply assume that Mr. Cummings was in violation of §16(b), and it should not undertake to decide this issue on the premise that the legislative policy of §16(b) mandates such an inquiry.

III

## THERE IS NO LEGISLATIVE POLICY MANDATING CAPITALIZATION OF §16(b) PAYMENTS

The government contends that the payment here at issue must be capitalized on the theory that to do otherwise would frustrate the purpose of §16(b):

> "The allowance of a deduction against income taxable at ordinary tax rates for the amount previously taxed at the preferential tax rates effectively operates as a Government subsidy of a Section 16(b) liability. Such a result would clearly contravene the purpose of Section 16(b) to squeeze out all insider profits." (Govt. brief, p. 21)

This argument is, of course, based upon the assumption that Mr. Cummings was guilty of violating §16(b). Since this assumption cannot be made, and since the Court should not undertake to determine whether Mr. Cummings violated §16(b), the government's legislative purpose argument need not be considered.

Even if the facts were different, it would be wrong to determine the income tax characterization of

this payment by reference to the legislative purpose of §16(b).

The legislative purpose of §16(b) is not profit-squeezing as such, but prevention of speculative trading by corporate insiders who are presumed to have access to information not generally available to the investing public. (S. Rep. No. 792, 73d Cong., 2d Sess., 9 (1934)). In interpreting §16(b), the Supreme Court has held that a pragmatic approach should be adopted, looking to the underlying purpose of §16(b), rather than the so-called objective test which focuses only on the literal words of §16(b):

> "In deciding whether borderline transactions are within the reach of the statute, the courts have come to inquire whether the transaction may serve as a vehicle for the evil which Congress sought to prevent - the realization of short-swing profits based upon access to inside information - thereby endeavoring to implement congressional objectives without extending the reach of the statute beyond its intended limits. The statute requires the inside, short-swing trader to disgorge all profits realized on all 'purchases' and 'sales' within the specified time period,

without proof of actual abuse of insider information and without proof of intent to profit on the basis of such information. Under these strict terms, the prevailing view is to apply the statute only when its application would serve its goals."

Kern County Land Co. v. Occidental Petroleum Corp., 93 S. Ct. 1736, 1744-45 (1973).

What the Supreme Court is saying in Kern County is that §16(b) is harsh enough in its flat prohibition of insider trading without reference to intent, and should not be extended in borderline cases unless clearly warranted by reference to the underlying purpose of §16(b) - prevention of speculative abuse.

The issue of whether the tax laws should be used to implement the purpose of §16(b) is such a borderline case. Is it necessary to prevent speculative abuse that, even though an insider has repaid a §16(b) profit, deductibility of the payment must be denied without regard to the facts and circumstances of the payment and without regard to any business purpose for the payment? How is the purpose of §16(b) served in Mr.

Cummings' case by denying deductibility, when the §16(b) problem was inadvertently caused, and the payment was made for valid business purposes wholly separate from any consideration or recognition of Mr. Cummings' potential §16(b) liability?

The government argues that permitting a deduction would permit the insider to profit indirectly by operation of the tax laws. (Govt. brief, p. 20). The concept is apparently that an insider might be encouraged to undertake short-swing trading if he thought that he could deduct a §16(b) payment and thereby realize a net tax profit. This result is doubtful. Whether or not a net tax profit could be realized depends upon too many variables not within an insider's control (such as his marginal tax rates, the aggregate of his tax deductions, and the timing of his stock trades and §16(b) payment) to warrant the risk attendant upon a knowing violation of §16(b). In addition to these uncertainties, the insider would then have to prove that the §16(b) payment was motivated by a valid business

purpose in order to establish deductibility of the payment. For an insider who knowingly engaged in short-swing trading, such a test would not only be difficult to meet but would also necessitate tax fraud. Thus, the business purpose requirement provides protection against the possibility of an insider deliberately engaging in short-swing trading to obtain a net tax profit.

One of the principal problems with the Seventh Circuit's decision in the Anderson case is its acceptance of the government's argument that allowing a deduction would frustrate the purpose of §16(b):

> "Without good reason we are unwilling to interpret the Internal Revenue Code so as to allow this anomalous result which severely and directly frustrates the purpose of Section 16(b). See United States v. Skelly Oil, 394 U.S. 678, 685, 89 S. Ct. 1379, 22 L. Ed. 2d 642; cf. Tank Truck Rentals, Inc. v. Commissioner of Internal Revenue, 356 U.S. 30, 78 S. Ct. 507, 2 L. Ed. 2d 562." (480 F. 2d at 1308)

Actually, the Seventh Circuit went far beyond even the government's position, in holding that the

Tank Truck Rentals case (356 U.S. 30 (1958)) was controlling. In that case, the Supreme Court denied a deduction for fines paid as a result of a deliberate and admitted violation of state law - operation of overweight trucks on the theory that it would be cheaper to pay the fines than to operate less than fully loaded trucks. But in Comm'r. v. Tellier, 383 U.S. 687 (1966), the Supreme Court carefully pointed out that it had intended the doctrine of Tank Truck Rentals to be extremely limited in scope, and refused to disallow a deduction for taxpayer's expenses in unsuccessfully defending a criminal prosecution.

> "Congress has authorized the imposition of severe punishment upon those found guilty of the serious criminal offenses with which the respondent was charged and of which he was convicted. But we can find no warrant for attaching to that punishment an additional financial burden that Congress has neither expressly nor implicitly directed. To deny a deduction for expenses incurred in the unsuccessful defense of a criminal prosecution would impose such a burden in a measure dependent not on the seriousness of the offense or the actual sentence imposed by the court, but

> on the cost of the defense and the defendant's particular tax bracket. We decline to distort the income tax laws to serve a purpose for which they were intended nor designed by Congress." (383 U.S. at 693-95.)

The Tax Court thoroughly considered and rejected the argument that §16(b) payments should be denied deductibility as a matter of public policy in <u>Laurence M. Marks</u>, 27 T.C. 464, 468-70 (1956). The Court held that, in view of the factors that (1) no determination of any §16(b) liability had ever been made, (2) there was no intent on taxpayer's part to violate the statute, and (3) the payment was made for the principal purposes of (a) protecting taxpayer's business reputation by avoiding unfavorable publicity and of (b) avoiding litigation expenses, the conduct which §16(b) was designed to discourage would not likely be fostered by permitting deductibility.

The Internal Revenue Service considered the implications of the <u>Marks</u> decision, and announced in Rev. Rul 61-115, 1961 Cum. Bull. 46, 48 that it would

no longer take the position that §16(b) payments were not deductible as a matter of public policy:

> "As distinguished from a statute which requires a wrongdoer to pay a specific amount, Section 16(b) merely shifts the benefit of the insider's dealings to the corporation. It extends the common law concept of a corporate officer's or director's fiduciary duty. The purpose of the statute is to place the insider in the same position he would have occupied if he had never engaged in the stock dealings. This purpose is not frustrated by the allowance of a tax deduction for amounts paid by reason of Section 16(b); but, rather, the allowance of the deduction is consistent with the purpose of the statute in returning the insider to his original position.
>
> Accordingly, upon reconsideration, it is held that a deduction for a payment to a corporation by an officer or director thereof, pursuant to or as a result of the requirements of Section 16(b) of the Securities Exchange Act of 1934, of the amount of profits derived in dealings in the capital stock of the corporation, will not be denied on the ground that it frustrates sharply defined public policy."

The Seventh Circuit's Anderson decision has, in effect, overruled both the Marks case and the Service's announced position in Rev. Rul 61-115 by declaring that

deductibility under §162(a) must be denied on public policy grounds. As the Tax Court held in <u>Marks</u>, and as Judge Campbell persuasively stressed in his dissenting opinion in <u>Anderson</u> (480 F. 2d at 1309) there is no sharply defined public policy enunciated in any governmental declaration that the purpose of §16(b) would be frustrated by denying deduction of a §16(b) payment <u>where the taxpayer is able to prove business motivation for making the payments.</u>

It is no answer that deductibility itself is not the issue here, but rather whether the deduction should be allowed against ordinary income or as a capital loss. Denial of even part of a deduction on a <u>Tank Truck Rentals</u> approach, which is the case in capitalization of an item, is no different in theory from denial of the entire deduction. Since the theory is inapplicable, any use of it is wrong.

Absent a <u>Tank Truck Rentals</u> situation, there is no justification for using the Internal Revenue Code

as an instrument of social policy, to promote what the government believes is the legislative intent of §16(b). It is for Congress - not the courts - to decide if appropriate legislation is necessary to harmonize §16(b) of the Securities Exchange Act and §162(a) of the Internal Revenue Code. In fact, Congress in 1969 thoroughly considered the deductibility of fines and penalties in its deliberations on the Tax Reform Act of 1969. As a result, the Tax Reform Act added Sections 162(c), 162(f), and 162(g) to the Internal Revenue Code, denying deductibility for illegal bribes, kickbacks, and other payments (§162(c)), for any fine or similar payment paid to a government for the violation of any law (§162(f)), or for two-thirds of any payment by a taxpayer criminally convicted of violating the antitrust laws (§162(g)).

At the time that the deductibility of these types of payments was under consideration by Congress, the Tax Court's decisions upholding deductibility of §16(b) payments had not yet been questioned by any

appellate court. And, yet, Congress did not see fit to legislate nondeductibility for §16(b) payments as it did for bribes, kickbacks, fines, penalties, and criminal antitrust damages. Neither should this Court.

IV

NEITHER ARROWSMITH NOR ANY TAX
BENEFIT RULE MANDATES CAPITALIZATION

Both the Sixth Circuit in Mitchell v. Comm'r, 428 F. 2d 259 (1970), and the Seventh Circuit in Anderson v. Comm'r, 480 F. 2d 1304 (1973) stated that their denial of deductibility was based upon the Arrowsmith doctrine, in each case disagreeing with the prior determination by the Tax Court that Arrowsmith does not apply to payments of this type.

The Tax Court has held on five separate occasions, in William L. Mitchell, 52 T.C. 170 (1969), rev'd 428 F. 2d 259 (1970); James E. Anderson, 56 T.C. 1370 (1971), rev'd 480 F. 2d 1304 (1973); Nathan Cummings, 60 T.C. 91, 61 T.C. 1 (1973), on appeal to 2d Cir.; and Charles I. Brown, 1973 CCH Tax Court Reports ¶32, 258(M) (1973), on appeal to 10th Cir., that the Arrowsmith doctrine does not apply to payments having a §16(b) genesis where taxpayer can prove that the payment was made for business purposes.

The persistence of the Tax Court in its interpretation of Arrowsmith, in spite of four opportunities to consider the Sixth Circuit's reasoning in Mitchell, and two opportunities (this case and the subsequent Brown decision) to consider the Seventh Circuit's approach in Anderson, reflects a fundamental and abiding disagreement over the implications of the Arrowsmith doctrine. Such a sharp division of opinion warrants the most careful consideration of the issue by this Court.

The Arrowsmith Case

In Arrowsmith v. Comm'r, 344 U.S. 6 (1952) stockholders who had been required to return amounts reported in earlier years as long-term capital gain on the liquidation of a corporation were required to treat the repayments as a long-term capital loss rather than a deduction against ordinary income.

It was conceded by taxpayers that, had the repayments occurred in the same year as their capital gains,

the repayments would have been properly treated as capital losses, since the repayments were directly and integrally related to taxpayers' capital transactions. (344 U.S. at 8) Taxpayers' argument was that the repayments should be ordinary business losses for the year in which the repayments were actually made because of the principle that each taxable year is a separate unit for tax accounting purposes. The Supreme Court held, however, that the annual tax accounting principle was not breached by referring to the prior capital transactions in order to classify the subsequent repayment for tax purposes. (344 U.S. at 8-9)

Properly construed, Arrowsmith stands for no broader proposition than the concept that an item may be classified for tax purposes by reference to a prior capital transaction, *if* the item is so directly and integrally related to the capital transaction that it would have been an adjustment to the gain or loss if it had occurred in the same taxable year. Arrowsmith does not provide the integral relationship; it builds on the premise that such a relationship exists.

The Skelly Oil Case

The tax benefit doctrine, which precludes double deductions, was neither raised by the government nor considered by the Supreme Court in Arrowsmith. Unfortunately, in United States v. Skelly Oil Co., 394 U.S. 678 (1969), the Supreme Court characterized Arrowsmith as a tax benefit decision:

> "The rationale for the Arrowsmith rule is easy to see; if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income." (394 U.S. at 685)

The result in Skelly Oil - in tax benefit terms - was eminently correct. Skelly Oil Company would have obtained a tax windfall if full deductibility of its repayments had been allowed, because it had taken the 27 1/2% depletion allowance when it had reported these receipts as income in prior years. Skelly Oil Company had, therefore, been taxed on only 72 1/2% of the receipts upon which it sought a 100% deduction when the receipts were returned to its customers.

As an application of the tax benefit doctrine, Skelly Oil has very narrow implications beyond the law as it then existed, which the Supreme Court itself recognized. (394 U.S. at 686) And except for characterizing Arrowsmith as a tax benefit case, Skelly Oil adds nothing to the Arrowsmith doctrine since Skelly Oil was a tax benefit case, and did not involve an Arrowsmith problem.

### The Mitchell Case

At the time that the Supreme Court decided Skelly Oil, the Tax Court had just decided the Mitchell case, holding that the Arrowsmith doctrine (without reference to Skelly Oil) did not require capitalization because there was no integral relationship between the payment and taxpayer's earlier stock transactions.

In Mitchell, a General Motors vice president had reported a long-term capital gain on the sale of GM stock in October 1962. In January 1963, he purchased additional GM stock. The sale followed by the purchase

within six months constituted the alleged violation of §16(b). Although never admitting liability, Mitchell paid GM his §16(b) profit, computed as the excess of his selling price in the 1962 transaction over the subsequent 1963 purchase price.

In holding that the payment was not integrally related to Mitchell's stock transactions, the Tax Court focused upon these facts:

> "In the instant case in 1962, when petitioner sold General Motors stock, he reported a long-term capital gain and paid the resulting tax. That gain was then his property without a claim against it on the part of anyone. It was a completed transaction. In 1963, petitioner purchased other shares of General Motors common stock at a price fixed by stock options owned by him. Upon this latter transaction, nothing of tax consequence took place. Only upon the sale or disposition of the purchased stock could it be said that anything with tax incidence had occurred. SECS. 1001, 1002, I.R.C. 1954. Because the purchase of the stock in 1963 took place within 6 months of the sale transaction, however, an entirely separate and distinct statute from the Internal Revenue Code was alleged to have come into operation, i.e., Section 16(b) of the Securities Exchange Act of 1934. Violation of Section 16(b) has no ipso facto tax

effect whatsoever but merely creates an indebtedness between an 'insider' officer of a corporation and his corporate employer.

It is noteworthy that there is no relationship between the amount of the capital gain realized upon the sale transaction to which respondent would relate the laws and the amount which 'inures' to the stock issuer under Section 16(b). The fact is that a violation of Section 16(b) could well occur where the sale transaction had actually resulted in a loss to the violator, but the measure of the amount which inures to the stock issuer under its provision remains the same. For example, if X corporation stock with the basis of $20 is sold for $10 ($10 loss), and within 6 months other X corporation stock is acquired for $5, under Section 16(b) there is a $5 'profit' that inures to X corporation." (52 TC at 174-75)

On appeal, the Sixth Circuit reversed, concluding that Skelly Oil made it clear Arrowsmith required a contrary result, and predicting that the Tax Court itself would have reached the same conclusion if it had known of Skelly Oil. (428 F. 2d 259, 262-63 (6th Cir. 1970)

For the Sixth Circuit, the key to the case was the tax benefit doctrine:

> "The taxpayer here, as in Skelly Oil, received income which was taxed at reduced rates, thereby receiving a tax benefit. In the present case, as in Skelly Oil, the taxpayer was required to give up a part of that income." (428 F. 2d at 263)

The integral relationship test of Arrowsmith, which the Tax Court had viewed to be the crux of the case, was treated only as an afterthought. The Sixth Circuit held that an integral relationship between the two stock transactions and the payment existed solely because the payment would not have been made but for the stock transactions. (428 F. 2d at 263-64)

The Anderson Case

One year after the Sixth Circuit's Mitchell decision, the Tax Court again considered the issue in James E. Anderson, 56 T.C. 1370 (1971), this time with the benefit of Skelly Oil. The Tax Court declined to

adopt the suggestion of the Sixth Circuit that _Skelly Oil_ made the _Arrowsmith_ doctrine applicable to §16(b) payment cases. (56 T.C. at 1374)

In the opinion of the Tax Court, a simple "but for" test was insufficient to establish an integral relationship requiring capitalization under _Arrowsmith_:

> "It is not enough that the relationship between two transactions is merely that 'the fruit of the first was the subject of the second.' See _Alvarez_ v. _United States_, 431 F. 2d 1261, 1264 (C.A. 5, 1970). There must be a sufficient nexus to require the conclusion that the later transaction was so integrally related to the earlier transaction that the transaction must be considered as parts of a unified whole. [citing authority]" (56 T.C. at 1376-77)

In other words, the _qualitative_ nature of the relationship between the stock transactions and the subsequent payment was the key question, and the Tax Court's analysis of this relationship in _Mitchell_ had not even been considered by the Sixth Circuit. Small wonder then, that the Tax Court in _Anderson_ did not

find the Sixth Circuit's decision to be persuasive.

In a thoroughly considered and convincing analysis of the implications of Skelly Oil for Arrowsmith, Professor Joel Rabinovitz of the UCLA Law School concluded that:

> "Not only is the Tax Court correct [in Anderson] that Arrowsmith does not require capital loss treatment of the Section 16(b) penalty, it also appears correct in its view that Skelly Oil itself would not compel such a result. The Sixth Circuit, unfortunately, accepting uncritically the Skelly Oil view of Arrowsmith, failed to understand the distinction between the two doctrines and was consequently unable to explore intelligently the scope of either." (Rabinovitz, "Effect of Prior Year's Transactions on Federal Income Tax Consequences of Current Receipts or Payments", 28 Tax Law Review 85, 94 (1972).)

Professor Rabinovitz did not discuss the Seventh Circuit's Anderson opinion, since the appeal was still pending at the time the Article was published.

If anything, the Seventh Circuit's considera-

tion of the Arrowsmith doctrine is even less persuasive than Mitchell. For the Seventh Circuit turned the Arrowsmith integral relationship test upside down and then resorted to the legislative purpose of §16(b) for the answer:

> "Although no 16(b) liability would have attached had taxpayer simply sold his stock and not made an advantageous repurchase within six months, the fact that liability is predicated on the sale-purchase occurrence does not mean the 16(b) payments were not integrally related to the earlier sale.[*] It certainly seems the most apt characterization to say that the payments represent a portion of the sales proceeds, and adjustment on the sale price.
>
> * * *
>
> Since there is hardly anything inevitable about whether the 16(b) payments inherit the capital character of the sales transaction, we think the purpose and operation of Section 16(b) relevant to the determination." (480 F. 2d at 1307)

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*Nor does that fact mean that there is any integral relationship, either.

In holding that taxpayer's §16(b) payment was directly and integrally related to his earlier stock transactions, the Seventh Circuit necessarily was forced to assume that the taxpayer had actually violated §16(b), and that the payment was in satisfaction of this statutory liability. Only by laying this predicate could the majority characterize the payment as an adjustment on the sale price of taxpayer's earlier stock transactions.

The Lack of an *Arrowsmith* Integral Relationship or Tax Benefit in This Case

Even if this Court were inclined to follow the reasoning of the Seventh Circuit in *Anderson*, as the government urges (Govt. brief, pp. 14-15) it likewise would first have to determine whether Mr. Cummings actually violated §16(b) since this issue has never been resolved. Absent the predicate of a §16(b) violation, it cannot be concluded that Mr. Cummings' payment was a §16(b) payment. Simple as it sounds, this point disposes of the *Arrowsmith* problem, since it can hardly be

argued that the payment was truly an adjustment to the sale price of Mr. Cummings' April 1961 MGM stock transaction without this foundation.

Beyond this, it is conceptually incorrect to style even an admitted §16(b) payment as an adjustment to the sale price of the prior stock transaction. The Tax Court in Mitchell correctly perceived that §16(b)'s matching provisions were neither designed to nor have any relationship to the Internal Revenue Code. When an insider engages in a pattern of stock trading which triggers §16(b), an artificial profit is statutorily created which is deemed to be an indebtedness between the insider and the corporation. This indebtedness - particularly where an insider's sale of stock is followed by a subsequent purchase within the 6-month period - is not profit in any income tax sense, and has no relationship to the income tax consequences of the insider's stock transactions.

The lack of relationship between the income tax consequences of the underlying stock transaction and §16(b)

insider's "profit" is graphically illustrated in the following table, which shows hypothetical gains or losses on stock transactions and the §16(b) "profit" involved:

| | | Example A | | | Example B | | |
|---|---|---|---|---|---|---|---|
| Date | Transaction | Price | Tax Result | §16(b) Result | Price | Tax Result | §16(b) Result |
| January | Purchase | $50 | $10 gain | | $50 | $10 loss | |
| March | Sale | 60 | | $20 "profit" | 40 | | $10 "profit" |
| May | Purchase | 40 | | | 30 | | |

It takes considerable sleight-of-hand to justify the position that, in these two examples, the §16(b) "profit" represents a repayment of gains from the underlying stock transactions.

Nor does this case involve a tax benefit problem. It cannot be said that Mr. Cummings was giving back part of his gain on the MGM stock sale without determining that a §16(b) violation occurred. But even an admitted §16(b) payment is not a return of capital gain in an income tax sense; it is an artificial profit measured by the matching of two stock transactions which may not - and in this case did not - have any income tax relationship.

Moreover, from either a tax benefit or an *Arrowsmith* standpoint, it is equally as apt to characterize a §16(b) payment as an additional cost of the subsequent stock purchase as an adjustment to the earlier stock sale. After all, in any §16(b) case, it is the second transaction within the six-month period that triggers liability - the first transaction by itself is meaningless. This is not to suggest that an adjustment to basis on the subsequent stock purchase is the correct result, but it does illustrate the artificiality of the government's approach. No tax benefit argument can be made unless the government can

style the payment as a return of money previously taxed at preferential rates, and so the government has been driven for reasons of its own choosing to focus on the sale transaction rather than the more logical subsequent purchase.* In any event, the government is stuck with its approach in this case, having failed to raise the alternative issue in the Tax Court.

The Irrelevance of the Origin of Claim Doctrine

This Court should not be misled by the government's citation of cases involving the origin of claim doctrine (Govt. brief, pp. 19-20) in support of its Arrowsmith and tax benefit contentions. The origin of claim doctrine involves neither Arrowsmith nor tax benefit, but rather whether payment by taxpayer of a

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*Professor Rabinovitz concurs that "Where, as in both Anderson and Mitchell, the requirement of repayment arises most directly from the purchase, the repayment should be treated as part of the cost of acquiring the new shares." (Rabinovitz, supra, at 109)

particular claim is motivated by a business purpose. Simply stated, the origin of claim doctrine stands for the proposition that it is not a sufficient business purpose to pay a claim not arising from a taxpayer's trade or business simply because the payment was made to protect taxpayer's interest in an asset. In Arthur H. Dugrenier, 58 T.C. 931, 939 (1972) the Tax Court succintly summarized the cases applying the origin of claims doctrine, and distinguished that rule from the factual situation involved here.

This issue is not present in this case, since the Tax Court directly held that Mr. Cummings' payments were motivated by valid business purposes - which the government does not seriously challenge.

## CONCLUSION

The Tax Court, which has lived with Arrowsmith for twenty years, is correct in resisting the government's efforts to convert the doctrine into a simplistic "but for" test to deny deductibility. It is time to straighten out Arrowsmith before the approach of the Sixth and Seventh Circuits becomes accepted dogma. The Tax Court should be affirmed.

Respectfully submitted,

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Dated: June 7, 1974

CERTIFICATE OF SERVICE

Glen H. Kanwit hereby certifies that four copies of Appellees' Brief were served upon counsel for the appellant by mail on June 7, 1974, with postage prepaid, addressed to Louis A. Bradbury, Tax Division, Department of Justice, Washington, D.C. 20530.

Glen H. Kanwit